The Law Society

Auditing and Ethical Standards, Implementation of the EU Audit Directive and Audit Regulation

Law Society Response

20 March 2015

Introduction

1. The Law Society is the representative body for over 159,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others. This submission has been prepared on behalf of the Society by members of its Company Law Committee and its Tax Committee both of which are made up of senior and specialist lawyers practising in their respective fields of law.

2. The Law Society is grateful for the opportunity to respond to the Financial Reporting Council's Consultation Request "Consultation: Auditing and ethical standards, Implementation of the EU Audit Directive and Audit Regulation" published December 2014.

Preliminary observations

3. In May 2014 the European Commission published a Directive amending the Statutory Audit Directive and a new Audit Regulation. The Audit Directive establishes specific requirements concerning the statutory audit of annual and consolidated financial statements. The Audit Regulation establishes further specific requirements regarding the statutory audit of 'public interest entities'. The new requirements come into effect on 17 June 2016 and will apply to financial years starting on or after that date.

4. The Audit Regulation has the direct effect of law and Member States are required to adopt appropriate provision to ensure its effective application. The Audit Directive does not have a direct effect in law and Member States are required to adopt and publish the measures necessary to comply with it. The Department for Business, Innovation and Skills (BIS) is seeking views on the implementation of the Audit Directive and Audit Regulation in the UK in its Discussion Document 'Auditor Regulation – Discussion document on the implications of the EU and wider reforms – December 2014'.

5. Articles in both the Audit Directive and Audit Regulation establish provisions that relate to matters that are the subject of the FRC's auditing standards and ethical standards for auditors. In relation to a number of these provisions there are Member State options. BIS and the FRC consider that it would be most appropriate for the application of the provisions that clearly relate to matters currently covered by the FRC's standards to be allocated to the FRC to implement via development of the audit and ethical standards framework and revision of the relevant standards.

Responses to consultation questions

The Law Society wishes to respond to only specific sections and questions set out in the FRC Consultation Request.

Section 3 – Extending the More Stringent Requirements for Public Interest Entities to Other Entities

Question 4: With respect to the more stringent requirements currently in the FRC's audit and ethical standards (those that are currently applied to 'Listed entities' as defined by the FRC) that go beyond the Audit Directive and Regulation: a) should they apply to PIEs as defined in	Yes

the Audit Directive? b) should they continue to apply to some or all other Listed entities as currently defined by the FRC? If so, which of those requirements should apply to which types of other Listed entities?	Yes; all.
Question 5: Should some or all of the more stringent new requirements to be introduced to reflect the provisions of the Audit Regulation apply to some or all other listed entities as currently defined by the FRC? If so, which of those stringent requirements should apply to which types of other Listed entities?	We consider that the second alternative approach set out at clause 3.13 (page 22) of the FRC Consultation document should be adopted. This will both maintain current FRC standards regarding Listed Entities and widen the scope of application and regulation to PIEs and in doing so would perhaps allay public concerns in relation to such entities.
Question 6: Should some or all of the more stringent requirements in the FRC's audit and ethical standards and/or the Audit Regulation apply to other types of entity (i.e. other than Listed entities as defined by the FRC, credit institutions and insurance undertakings)? If yes, which requirements should apply to which other types of entity?	Yes; there is good reason to extend this application to other legal entities that are clearly of public interest.

Section 4 – Prohibited Non-audit services

Question 7: What approaches do you believe would best reduce perceptions of threats to the auditor's independence arising from the provision of non-audit services to a PIE (or other entity that may be deemed of sufficient public interest)? Do you have views on the effectiveness of (a) a 'black list' of prohibited non-audit services with other services allowed subject to evaluation of threats and safeguards by the auditor and/or audit committee, and (b) a 'white list' of allowed services with all others prohibited?	We consider that a 'white list' approach should be adopted as this would raise the public's perception of an auditor's independence by providing clarity as to what is and what is not, permissible.
Question 8: If a 'white list' approach is deemed appropriate to consider further: a) do you believe that the illustrative list of allowed services set out in paragraph 4.13 would be appropriate or are there services in that list that should be excluded, or other services that should be added? b) how might the risk that the auditor is inappropriately prevented from providing a service that is not on the white list be mitigated?	The 'white list' should be non-exhaustive. Having the 'white list' will provide clarity (see question 7 reply above) but being clearly labelled as non-exhaustive allows flexibility to the non-audit service sector without implying that services not listed are automatically to be considered as prohibited. A system of audit committee determination could be introduced whereby an auditor could apply for a non-white list service to be added to that list or alternatively, considered and determined to be appropriate (derogation).
Question 9: Are there non-audit services in	No comment.

addition to those prohibited by the Audit Regulation that you believe should be specifically prohibited (whether or not a 'white list' approach is adopted)? If so, which additional services should be prohibited?	
Derogations in respect of certain prohibited non-audit services	
Question 10: Should the derogations that Member States may adopt the under Audit Regulation – to allow the provision of certain prohibited non-audit services if they have no direct or have immaterial effect on the audited financial statements, either separately or in the aggregate – be taken up?	We do not have a view on this. However, we would make the observation that in our experience, in the audit, audit firms appear to test more thoroughly the tax advice given when firms outside of their network are advising on tax as compared to the situation where their own firm or network is advising on tax. Also, we have observed that audit firms sometimes take on audit work as a loss-leader with a view to selling other non-audit services to their audit clients. It appears to us that this can compromise the integrity of the audit. If the derogation (or opt out) is taken up by any Member State, conditions are attached in article 5(3) of Regulation No 537/2014. Essentially, these conditions include that the opted out services have no direct or have immaterial effect on the audited financial statements (see question 11 answer below). There is a further condition to the use of any tax opt out mentioned in recital 9 to the Regulation. The recital explains that *where such services involve aggressive tax planning, they should not be considered as immaterial*. It goes on to say by way of illustration that a*ccordingly, a statutory auditor of an audit firm should not provide such services to the audited entity*. Although the Regulation has direct effect, we assume that the FRC will be planning to take this absolute prohibition on the provision of aggressive tax planning services into account in any guidance it gives on the Regulation if the opt out is taken up, so that it can provide comprehensive guidance to the accounting profession? How will the FRC expect to implement this aspect of the Regulation in the UK assuming that the opt out for certain tax services is exercised? Also, how will the FRC define "aggressive tax planning" services for these purposes?
Question 11: If the derogations are taken up, is the condition that, where there is an effect on the financial statements, it must be	'Immaterial effect' is a sufficient indicator to be adopted.

'immaterial' sufficient? If not, is there another condition that would be appropriate?	
Question 12: For an auditor to provide non-audit services that are not prohibited, is it sufficient to require the audit committee to approve such non-audit services, after it has properly assessed threats to independence and the safeguards applied, or should other conditions be established? Would your answer be different depending on whether or not a white list approach was adopted?	See reply to question 8b above. This would apply if a 'white list' approach is adopted. Should a 'black list' approach be adopted then we presume that such black list would be exhaustive as to prohibited services and derogations would simply not be permitted?

Contact Information

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